

## **6. Speculative Results**

DRA believes that PBOP are too speculative to warrant rate recovery at this time. DRA questioned the availability and reliability of data necessary to measure the employers' PBOP obligations and costs. This concern was also identified in the Statement. DRA also contended that the decision on how and when to fund the obligation should not be related to when the obligation is incurred. One other major contention was that the growth components and inflation factors for labor and non-labor costs do not adequately capture medical cost increases.

Similar concerns were addressed in OII 86, and in response to our flexibility criteria to implement a decommissioning funding method. Flexibility was a primary criterion in that investigation because the mechanism being adopted had to be responsive to technical, economic, legal, and political conditions over at least the next 30 years. The same needs hold true in this proceeding.

In view of the many uncertainties, we deem it very important that the financing mechanism adopted in this order be adaptable. Consistent with this position, the funding mechanism and payments should be evaluated in each operating utility's GRC or other rate proceeding. At that time, operating experience and any changes in cost-related factors would be reviewed and adjustments made similar to the review controls implemented by Ordering Paragraph 7 of our Phase I decision.

## **X. Alternative PBOP Funding Sources**

Traditionally, operating costs are paid for by the utilities' ratepayers. However, because of the magnitude of PBOP liability and future costs, we were interested in considering alternative funding mechanisms. Alternative sources included shareholder contributions, employee contributions, and the transfer

of funds from other funds such as pension funds. Parties were requested to address such alternative sources.

**A. Shareholder Contributions**

Shareholder contributions can be a potential source for funding PBOP benefits. However, Edison and other utilities pointed out that the basic cost of service ratemaking procedure dictates that the utilities should have the opportunity to receive sufficient revenue in rates to recover their reasonable operating expenses, including PBOP costs, taxes, and a fair return on invested capital.

As early as 1914, the Commission held that the real controlling element in fixing rates is what it costs the utility to perform the service, Fesler v Pacific Tel. & Tel Co., 4 Cal R.R.C. 711 (1914). Subsequently, the U.S. Supreme Court clearly established in F.P.C. v Hope Natural Gas Co., 320 U.S. 591 (1944), that shareholders in regulated firms must be allowed the opportunity to earn returns that are sufficient to attract capital and are comparable to those they would expect in the unregulated sector for bearing the same degree of risk.

As delineated in the aforementioned Fesler and Hope Natural Gas Co. decisions, the utilities' cost of doing business, including PBOP costs, is properly recoverable from ratepayers through the cost of service. Unless the regulatory policy of allowing utilities to recover reasonable costs incurred in the performance of utility service is changed, which we do not intend to do at this time, the use of shareholders' funds to pay for PBOP benefits is not a viable alternative to ratepayer funding.

**B. Employee Contributions**

Another alternative to ratepayers funding PBOP could be employee contributions. In this regard, DRA does not believe that the utilities have seriously considered the cost shifting of health care costs. Therefore, DRA recommended that the utilities become more pro-active in labor negotiations to minimize ratepayer burden

in funding PBOP and that the utilities work toward the establishment of health cost containment programs and a shift of employers' PBOP costs to their employees.

DRA specifically recommended that the cost containment program be restructured in a way that benefits would be provided by giving the employers more control over what prices are charged. This could include the establishment of health maintenance organizations and preferred provider organizations and giving the employee a direct role in the drafting of insurance contracts and the price schedules for medical procedures and services.

Alternatively, DRA recommended that defined contribution PBOP plans, similar to defined contributions pension plans, could be established whereby the employer allocates a specified amount to each employee's account and relinquishes the investment decisions to the employee through investment options available in the market.

Under DRA's alternative scenario, the employee would be responsible for using the money to purchase health insurance after retirement. Pursuant to such an arrangement, the contributions would be tax deductible for the employer and by definition, the employer will have no PBOP liability beyond its annual contribution, even though contributions may not cover the entire amount of health insurance costs incurred during retirement. However, any PBOP received by an employee may be taxable to the employee.

DRA's proposal to shift PBOP costs from employers to employees is not a new idea and has already been aggressively implemented by many of the utilities. For example, Pacific Bell has taken steps to involve retirees in the payment of health care cost. Effective January 1, 1993, Pacific Bell limited its contribution towards the cost of retiree medical benefits for all employees who retire on or after January 1, 1991 and restricted Medicare Part B premiums.

Similarly, SDG&E has implemented PBOP cost containment and employee sharing programs. In SDG&E's case, those employees who retired prior to January 1, 1987 pay a portion of the medical insurance premium for their dependents age 65 and over, and those who retire after December 31, 1986 pay the difference between a fixed monthly contribution by SDG&E and the full cost of medical coverage.

As acknowledged by DRA, any change to PBOP applicable to represented employees would require the utilities to negotiate with their employee unions. Under the National Labor Relations Act (NLRA) regulators and others are precluded from prescribing outcomes for collectively bargained agreements. This means that management and labor negotiate or otherwise agree to any compensation levels or arrangements free from outside interference, regulatory or otherwise. However, there is no regulatory assurance that unfair or unreasonable arrangements will receive rate recovery. Such assurance has generally been reserved for GRC type proceedings where employee benefits and costs are closely scrutinized in unison with the results of the total negotiated package.

PBOP cost containment and shifting of PBOP costs from the utilities to the employees are viable supplements to the PBOP revenue recovery issue. However, such activities will not replace the need for ratepayer funding. Therefore, employee funding is not viable as a complete alternative funding source for PBOP costs.

The utilities are encouraged to continue with their PBOP cost containment programs and employee sharing efforts to the extent that such activities result in fair and reasonable costs for the services being provided. At the same time, DRA is encouraged to continue monitoring and reviewing the reasonableness of the utilities' PBOP cost activities.

**C. Pension Funds**

Excess pension assets are another potential source for funding PBOP. Pension plans could be used two ways to fund PBOP.

First, existing pension plans could be modified to include PBOP. The advantage of this method is that a utility's PBOP contribution would be tax deductible and the plan income would be tax free with the provision for unlimited contributions so long as they are reasonable, necessary, and do not exceed the maximum benefit limits. There are two major disadvantages. First, the utilities would need union approval. Second, it would transform PBOP, which are tax free to retirees, into a taxable benefit in the form of pension payments. The taxability to retirees may result in higher cost to the ratepayer unless the utilities can negotiate a non-monetary benefit with the unions for giving up a tax-free benefit.

The second method of utilizing the pension fund as a source of PBOP funding was created by the passage of the Omnibus Budget Reconciliation Act of 1990. This allows employers to transfer annually a certain portion of excess pension assets to an Internal Revenue Code (IRC) § 401(h) retiree medical account. The primary disadvantage of this method is that IRC § 420 provides for limited transfers of excess pension assets to a § 401(h) account only for the years 1991 through 1995, and only if the pension plan is in full funding and if assets exceed 125% of the current liability. This method would also require acceptance by the unions.

The second method could be applicable to only those utilities that have surplus pension assets as defined by the IRS. Most do not. To date, only the major telephone utilities, such as GTEC and Pacific Bell, are alleged to have surplus pension assets. However, even DRA acknowledged that the conditions imposed in the Omnibus Budget Reconciliation Act of 1990 make it unlikely that the utilities with surplus pension funds will transfer pension funds to

pay for PBOP. Finally, an analysis of the cause of the surplus situation would be necessary to obtain reasonable assurance that the surplus situation will not be reversed in a subsequent year, resulting in additional or excessive costs to the ratepayers. Such assurances are unlikely to be available.<sup>17</sup>

DRA has recommended that PBOP costs be used only to pay for PBOP. If DRA's recommendation is to be adopted, consistency should prevail. Similar to restricting PBOP costs to pay for only PBOP, pension costs should be restricted to pay for only pension benefits. Surplus pension assets, as they occur, should be investigated and, if necessary, adjusted in GRC or other rate proceedings. The use of surplus pension assets is not a viable alternative source of funding PBOP costs at this time. However, we do not want to preclude utilities from using surplus pension assets to fund PBOP expense. Therefore, to the extent that the IRS lifts its restrictions and the employee unions agree to the use of surplus pension assets to fund PBOP expense we fully expect the utilities to do so.

**D. Summary of Alternative Sources to Fund PBOP Costs**

None of the alternative funding sources is a viable option to ratepayer funding. However, except for stockholder funding, the alternative sources along with the tax deductible funding plans identified in Ordering Paragraph 4 of D.91-07-006 can be used to supplement and reduce ratepayer funding.

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<sup>17</sup> Generally, surplus and deficit pension assets result from volatile changes in the investment markets which cannot be predicted with any accuracy. Just such a situation occurred on October 19, 1987, more commonly known as Black Monday, the day which the Dow Jones Industrial Average dropped 508 points, the largest single drop, both numerically and as a percentage, in its history, 27 CPUC 2d at 550. Similarly, Pacific Bell explained that its pension assets experienced a \$1 billion loss in 1990 due to highly volatile investment markets.

## **XI. Regulatory Accounting and Ratemaking Adoption**

Cost of service is an indispensable factor in setting fair and reasonable rates for regulated service. Even the rates for telecommunication utilities under the NRF are based on cost of service. Specifically, NRF adopted a form of incentive regulation based on the utilities' cost of service. In addition, a Z factor adjustment was implemented to reflect exogenous factors which could affect utility costs to an extent warranting an explicit rate adjustment, decreases as well as increases. Therefore, if we are to adopt the Statement for regulatory accounting purpose, we must find that the Statement meets the Commission's cost of service criterion, which distributes the cost equitably over time among the ratepayers who benefit from the service being performed.

### **A. Regulatory Accounting**

There was no dispute that PBOP costs are a legitimate cost of providing service. The dispute, fostered by DRA, was that only the cash basis of accounting would reflect how PBOP are being provided by the utilities.

According to DRA, the contracts between the utilities, their unions, and PBOP providers, stipulate that PBOP claims must be paid as incurred, on the cash basis. More specifically, DRA contended that PBOP are deemed to be earned upon retirement and not over the working life of the employee, and that employees are not entitled to receive PBOP until they retire and incur claims. Further, unlike pensions, employees do not earn additional benefits for each additional year worked nor are the employees legally entitled to receive the benefit until they retire and incur costs.

However, DRA did not substantiate its assertions. Excerpts from the utilities' retiree's benefit handbooks (attached to DRA's Exhibit 75 as Appendix 6) did not confirm DRA's conclusion that PBOP are earned upon retirement. On the contrary, the appendix confirmed that employees do not qualify for PBOP unless they specifically provide service for a specific minimum period of time.

"To earn" is defined as "to gain or [to] deserve for one's service, labor or performance."<sup>18</sup> In other words, nothing is given for free. In the case of Edison, employees who retire from Edison on or after January 1, 1991 who were hired prior to August 1, 1983, or who complete at least 10 years of service prior to retirement will receive medical, dental, and vision care coverage. Therefore, Edison employees must dedicate a minimum of 10 years of their working life to receive any PBOP.

Employees may not be entitled to receive PBOP until they retire and actually incur cost. However, except for the incurrence of cost, the same principle is applicable to employees receiving pensions. The incurrence of cost is a different matter. Although PBOP do not provide for a defined payment, the benefits are based on actuarial assumptions very much like pension benefits. As a matter of fact, the PBOP actuarial reports offered into evidence, such as PG&E's, applied actuarial assumptions consistent with the actuarial assumptions used in their pension reports.

We find DRA's argument that employees do not earn additional PBOP for each additional year worked as they do for pension benefits to be a red herring. If DRA considered the above-mentioned Edison example, it would find that the longer the employees work for Edison, the lower cost the provision of benefits by Edison's ratepayers. That is, if every Edison employee retired after 20 or 30 years of service instead of after 10 years of service, the cost of PBOP, assuming no reduction in work force and no change in benefits, would substantially decrease to the ratepayers because the same cost would be spread over an additional 10 or 20 years depending on whether the employees retire upon 20 or 30 years, respectively.

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<sup>18</sup> 1976 edition of the New College Edition of the American Heritage Dictionary of the English Language.



DRA also pointed out that PBOP are difficult to determine because a majority of the utilities' plans allow the utilities to amend or even terminate the plans. For example, Edison provided in its collective bargaining agreements that Edison may modify the PBOP plans to provide any benefits prescribed by law, or to minimize the adverse impact on cost imposed by law, tax, or regulatory authority. The agreement also provided that such modifications would not, except as provided in its plans, increase the cost of such benefits to retirees. Similarly, Pacific Bell reserved its right to modify the plans at any time.

Although the benefit plans may be subject to change, approximately one-third of the TBO, as testified to by SoCal Gas, represents benefits for retirees. Edison testified that approximately one-third of its 1993 accrued expense would relate to its retirees. As explained in DRA's exhibit, there are a number of court decisions that have held that postretirement welfare benefits are "status" benefits which, in fact, do vest upon retirement and therefore, employers are unable to terminate or modify plan benefits for retired employees. This means that benefits applicable to one-third of the TBO would not be affected by a change in plan benefits.

The remaining two-thirds and the yearly accrual applicable to current employees could be subject to change. However, similar to the determination of pension benefits, actuarial reports would be performed on a periodic basis to reflect changes in actuarial assumptions, including plan benefits, inflationary factors, and mortality rates. With the results of periodic actuarial reports PBOP costs may be adjusted within a reasonable period of time to fairly accurately reflect the cost of current PBOP.

The utilities argued that, in the past, the cash basis of accounting for PBOP costs was the acceptable practice because the obligation was not a significant amount of money. However, with

the recent escalation in health care costs and increased longevity of retirees it became very apparent to them that there was a need to recognize these obligations on a current (accrual) basis to more accurately represent the net periodic PBOP costs and liability in a consistent manner. The utilities believe that the Statement must be adopted for accounting purposes if their regulatory financial statements are to properly reflect the periodic PBOP costs and liability in a manner consistent with its cost to provide utility service.

Absent evidence to the contrary, we must conclude that the Statement's method of accounting for PBOP on the accrual basis meets the cost of service criterion. Therefore, the Statement should be adopted for regulatory accounting purposes to properly reflect cost of service in the utilities' financial statements.

**B. Ratemaking Recovery Procedure**

Although the Statement is being adopted for regulatory accounting purposes, there is no requirement that PBOP be funded on a basis consistent with the Statement. The Statement specifically concluded that the decision on how or when to fund the PBOP obligation is a financing decision and not an accounting issue.

Therefore, we may require the utilities to fund PBOP on the cash basis as recommended by DRA or the accrual basis as recommended by the utilities. The Department of Navy did not clearly explain its position on whether the cash basis or accrual basis of accounting should be adopted.<sup>19</sup> To the extent that full

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<sup>19</sup> In its brief, the Department of Navy recommended that rate recovery be restricted to the cash basis until "much of the uncertainty is resolved" concerning developments affecting health care. However, its witness testified under oath that ratepayers should pay for PBOP costs on the accrual basis to the extent that the utilities are able to use tax-advantaged funding methods. Its

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funding is not authorized, the Statement acknowledged that regulated utilities may establish a regulatory asset and/or liability as identified in FASB's Statement No. 71 (Statement No. 71), accounting for the effects of certain types of regulation.

This is the appropriate place to utilize the assurance,<sup>20</sup> cost,<sup>21</sup> flexibility,<sup>22</sup> and equity<sup>23</sup> criteria.

OII 86 established four criteria useful to compare the cash basis of revenue recovery with the accrual basis of revenue recovery (Navy and utilities). They are assurance, cost, flexibility, and equity.<sup>24</sup>

Under the cash basis of revenue recovery, there would be no advance provision for PBOP. The cost associated with PBOP would be considered normal utility operating expenses and collected from

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(Footnote continued from previous page)

witness also testified that if PBOP prefunding amounts were included in rates that the recovery of this expense would be on a more consistent basis with the recovery of pension expense and nuclear decommissioning costs.

20 The degree of certainty that the operating utility will have sufficient funds available to pay the cost.

21 The cost which operation of the financing mechanism adds to the total cost of PBOP costs.

22 The ability to respond to changes relevant to factors such as inflation, cost escalation, tax treatment, and the ability to make the best interim use of funds.

23 To charge ratepayers at any given time in relation to the net benefits they are receiving.

24 Although the utilities recommended variations to the accrual basis ranging from the recovery of only tax-deductible cost to recovery of the entire accrual required by the Statement, no differentiation was given to the various accrual levels in the comparison.

the ratepayers in the year that the utilities pay the expense. Adequate funding would be guaranteed only by timely regulatory approval of increased PBOP expenses and by the ratepayers' ability to absorb the additional costs. Clearly, given the parties' agreement that PBOP costs are substantial and increasing, the cash basis of accounting cannot meet the assurance or flexibility criteria.

It could be argued that the cash basis meets the cost criterion. However, this is questionable. As addressed in our time value of money discussion, there was considerable disagreement over the relative present value analysis of the various recovery proposals. Although, as a general principle, the present value of a payment falls if it is postponed further into the future, DRA's present value analyses failed to reflect the substantial accumulated cash investment in trust that would be available to fund PBOP at a future period of time.

Most importantly, the cash basis of recovery ignores equity because it fails to incorporate the cost of service principle of charging ratepayers at any given time in relation to the net benefits they are receiving. Instead, it exacerbates inter-generational inequity.

On the other side, the accrual basis of revenue recovery would meet the assurance criterion and provide a degree of certainty that sufficient funds will be available to pay the utilities' PBOP costs to the extent that such funds were reasonably invested, such as in the Trust plans approved in the first phase of this investigation.

Cost should not be an adverse factor if an accrual revenue recovery mechanism is authorized. Differences may occur depending on whether payment is impacted by the utilities' net-to-gross factor.

The flexibility criterion would also be met because the utilities would be able to assess PBOP on an ongoing basis and make

periodic changes in response to components such as inflation, plan changes, cost escalation, and tax treatment. Periodic scrutiny and adjustment of such costs prior to actual incurrence would be possible through actuarial reports and through rate review proceedings.

Most importantly, the accrual recovery method would ensure that the equity criterion is met and that the current inter-generational inequity is resolved. Recovery of the annual accrued PBOP costs in rates would assure that the same generation of utility customers who were the recipients of that employee's service, paid the costs of an employee's benefits. Further, considering the trend toward increasing competition in the energy and telecommunications markets, deferring the payment of PBOP obligations to the future may prove to be a substantial burden to a smaller base of ratepayers.

Upon consideration of the cash and accrual bases in relationship to the financing criteria, we conclude that the cash basis is inequitable. The accrual recovery method would provide a reasonable approach for the recovery of PBOP costs and balance ratepayers' interests with the stockholders' interests. Therefore, the utilities should use the accrual method for ratemaking recovery of PBOP expense effective January 1, 1993.

#### C. Attribution Method

The Statement requires that the "benefits/years-of-service approach" be used to assign PBOP costs to periods of employee's service. This approach assumes that the total benefit is earned equally over the period from an employee's date of hire to the employee's "full eligibility date," which is the date on which an employee has completed the contractual requirements for eligibility for all PBOP the employee is expected to receive.

For example, under PG&E's medical plan, employees are entitled to retire and to receive PBOP at age 55. If an employee starts working for PG&E at age 25, the Statement's attribution

method would require PG&E to recognize the employee's PBOP costs from the date hired through the employee's 55th birthday, even though the employee is expected to work an extra 10 years, until the employee is 65.

The Department of Navy identified industry concerns regarding the Statement's attribution method, including its failure to assign costs of providing the PBOP over the employee's entire expected working life, and its resulting in an unduly accelerated recognition of the PBOP obligation and its corresponding expense.

Although no party presented any testimony on what impact the employee's total expected service life attribution method would have on the utilities' PBOP cost and liability, the Department of Navy does not believe that benefits/years-of-service attribution method would be desirable for ratemaking purposes. Therefore, it recommended that the employee's total service life attribution method be considered in recognition that something less than the full Statement accrual amount would be a more appropriate cost level to reflect in rates.

Although not identical, a similar situation existed in Investigation (I.) 87-02-023 in which we considered whether the Federal Communications Commission's USOA should be adopted for telephone companies under our jurisdiction, 27 CPUC 2d at 550. Specifically, at issue was whether the cost of employees' estimated pension benefits should be recovered over the future working lives of the employees or whether the unit credit method should be adopted. Under the "unit credit method" the cost of employees' pension benefits would increase each year to recognize increased benefits earned. In other words, the cost would increase each year to reflect an increase in age, an additional service year, and any change in pension benefits due to any salary change.

In that investigation, we concluded that employees are promised benefits at retirement and that benefits at retirement are what the employee is actually earning. We also concluded that the

assignment of a consistent amount of pension expense from year to year was reasonable and should be adopted.

Similar to the unit credit method, the benefits/years-of-service method would provide for a disproportionate allocation of benefits cost over the employee's working life. However, in this instance, the cost would be front loaded with cost assigned to the employee's early working life with little or no cost assigned to the later years of the employee's working life. Consistent with our USOA investigation, it is reasonable to flow through the cost of the employee's PBOP benefits over the employee's entire working life. Therefore, the utilities should use the employee's total utility service life attribution method of distributing the cost of employees' PBOP for both the TBO and ongoing PBOP costs. The Statement's benefits/years-of-service approach should not be adopted. However, in these instances where the utilities can substantiate to CACD that the benefits/years-of-service approach would result in no differences in expense or would result in minimal<sup>25</sup> differences the benefits/years-of-service approach may be used. Such substantiation should be made prior to January 1, 1993.

**D. TBO Amortization**

The Statement provided the utilities an option of amortizing the TBO over the average remaining service period of their active employees' service life or over a 20-year time period.

Irrespective of the regulatory method adopted for recovery of the utilities' projected \$5 billion TBO, inter-generational inequity will continue to exist until such costs have been fully amortized. However, this inequity will be substantially

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<sup>25</sup> Minimal, in this specific instance is defined as 10% (percent) or less than the total utility service life attribution method.

mitigated because the TBO is not applicable solely to retired employees.

According to SoCal Gas's testimony, only one-third of its respective TBO is applicable to retired employees. This means that the remaining two-thirds is applicable to employees currently in their work force and expected to remain in that work force for a number of additional years. Therefore, to the extent that the TBO applicable to current employees is amortized while the active employees continue to work, the inter-generational inequity would be mitigated.

To put this in perspective we considered the inter-generational inequity impact on SoCal Gas, whose current employees were expected to have an average future working life of 20 years. If the 20-year amortization period is adopted, then two-thirds of SoCal Gas's TBO would escape inter-generational inequity, and only one-third, or \$88.7 million of its \$266 million total TBO would result in inter-generational inequity. This means that if each utility's experience factors matched SoCal Gas's retired employees' TBO ratio of one-third and SoCal Gas's current employees' average future working life of 20 years, then amortization of the \$4,742 million total TBO for all utilities would result in a \$1,580.8 million inter-generational inequity instead of a perpetual inter-generational inequity under the current cash basis of recovery.

The 20-year TBO amortization method will not eliminate inter-generational inequity. However, it will substantially mitigate the inequity. If the average future working life of the utilities' employees exceeded 20 years, then the inequity would be further mitigated. The record is incomplete on this issue and we find it highly unlikely that such a situation would exist. Therefore, to assure equal treatment among the utilities we will require the utilities to utilize a 20-year amortization period for their respective TBO.



**E. Recovery of PBOP Accrual**

Two distinct recovery proposals for regulatory ratemaking were recommended if the Statement is adopted. One proposal was that rate recovery be limited to only those contributions made to tax-deductible plans, similar to the authority granted for pre-funded contributions in the first phase of this investigation. Those parties that recommended the tax-deductible proposal included the Department of Navy, PG&E, SoCal Gas, and Southwest Gas. DRA also endorsed the tax-deductible proposal to the extent that such plans would accumulate earnings tax-free.

The other proposal was the full recovery method whereby utilities would recover their entire PBOP contributions currently, whether placed in tax-deductible or taxable plans. Parties that recommended full recovery included Edison, GTEC, Pacific Bell, and SDG&E.

We have already taken steps to mitigate rate shock by requiring the utilities to use the employee's total service life attribution method, except in those instances where the utilities can substantiate that the benefits/years-of-service approach will have minimal impact, in assigning PBOP costs to the periods of time that employees actually provide utility service and by adopting a 20-year amortization period of the TBO. However, to authorize the utilities full recovery would place an unnecessary financial burden on ratepayers. This is because the non-tax-deductible proposal would require ratepayers to compensate the utilities for income taxes applicable to the non-taxable contributions. In other words, ratepayers would be required to pay an additional \$670,000 for every \$1 million that the utilities contribute to such a plan, according to DRA's net-to-gross calculations, with no additional benefit going to ratepayers.

Clearly, the tax-deductible recovery proposal would better balance the relative interests of shareholders and ratepayers. Ratepayers would be required to pay a reasonable cost

of service and shareholders would be given a reasonable assurance that PBOP costs would be recovered from ratepayers. This stockholder assurance would be provided by the establishment of a regulatory asset which would reflect the difference between the utilities' total PBOP liability and the amount currently being paid by ratepayers. Therefore, the water, energy, and telecommunications utilities under traditional ratemaking process and the telecommunications utilities under the NRF should recover their PBOP costs in rates to the extent that they are able to make tax-deductible contributions to tax-deductible plans.

The choice of tax-deductible plans is a management decision which should be made by the individual utility. To provide utility management greater flexibility in funding and controlling PBOP costs and benefits, the utilities should be granted authority to implement trusts whose earnings may be taxable to the trust or to the employees.

**F. Regulatory Asset**

The utilities generally maintain two sets of financial statements, one for regulatory purposes and the other for external purposes (e.g., for the Securities and Exchange Commission (SEC) and shareholders). For external (non-regulatory) purposes the utilities are required to prepare their financial statements in accordance with the FASB accounting standards. Although FASB allows utilities to reflect a regulatory asset in their external financial statements, financial statements integrity requires regulatory assurance that the regulatory asset will be recoverable in future rates.

**1. Regulatory Assurance**

FASB's Statement 71 provides specific guidance in preparing general purpose financial statements by regulated utilities. Among other components, Statement 71 allows for revenues intended for the recovery of costs to be provided for in rates either before or after the costs are actually incurred by the

utilities. Therefore, in those instances where a regulatory agency, such as this Commission, provides assurance<sup>26</sup> that already incurred costs will be recovered in the future, the utilities are required to capitalize those costs as a regulatory asset. This new asset represents future cash inflow that will result from the ratemaking process.

To qualify as a regulatory asset there must exist probable cause to believe that the full amount of the capitalized regulatory asset will be recovered in future rates. In addition, there must be reasonable assurance that future revenues will be provided for the cost recovery of the regulatory asset, rather than the expected levels of similar future costs. Absent such assurance, the utilities would be required to expense their unfunded PBOP costs for external financial statement purposes thereby reducing their operating incomes which, in turn, would adversely impact their financial positions.

a. Traditional Cost of Service Regulation

DRA believed that the cost-effectiveness standard, which measures the reasonableness of cost, would provide sufficient regulatory assurance to enable utilities to record deferred PBOP costs as a regulatory asset under Statement 71. DRA relied on the minutes of a April 19, 1991 meeting between the SEC and the American Institute of Certified Public Accountants' Public Utilities Committee (AICPA Committee). The minutes read, in part, that the SEC staff believes that if the regulator has indicated it

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<sup>26</sup> FASB No. 71 provides for the recording of an asset in those instances where rate actions of a regulator can provide reasonable assurance of the existence of an asset to the extent that it is probable, or believed on the basis of available evidence or logic, but is neither certain nor proved, that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.

will allow the costs in rates on a pay-as-you-go basis, PBOP accruals may qualify as regulatory assets.

DRA does not, however, believe that Commission policy should be driven solely by whether or not utilities can record a regulatory asset under Statement 71. Rather, DRA believes that sound regulatory policy requires that recovery of PBOP costs be driven by economic efficiency, cost-effectiveness, and prudence.

The utilities relied on the same meeting minutes. However, they concluded that the SEC was concerned about the lack of evidence presented by registrants supporting the deferral of incurred costs under Statement 71. Edison explained that DRA overlooked that the minutes of the meeting further stated that the SEC staff recognizes and believes that the PBOP regulatory asset concerns expressed by the AICPA Committee are valid and that the SEC staff indicated they would like to continue discussions with the Committee on this issue.

Subsequent to the April 1991 meeting, the AICPA Committee chairperson informed Edison that a majority of the Committee members had serious problems with allowing the creation of a regulatory asset for the utilities to record the difference between the pay-as-you-go method and the Statement method. However, the chairman indicated that a majority of the members felt that if tax-deductible funding were recoverable in rates and regulatory assurance were provided for future recovery of the excess PBOP expense, strong enough evidence would exist for utilities to set up a regulatory asset under such conditions.

SDG&E further explained that the large dollar amounts, trends, periods covered, and changing regulatory and business environments make it difficult to obtain reasonable assurance that PBOP cost recorded as a regulatory asset will be recoverable in the future.

Both DRA's and the utilities' understanding of what transpired at a meeting between the SEC staff and AICPA Committee

are based on incomplete information. However, it is apparent that the SEC has not taken a policy position on what criteria should be used to determine whether a regulatory asset should be allowed or what level of assurance needs to be given by the regulatory agencies.

We find it interesting that the SEC, and not the FASB which established Statement 71 and the mechanism for recording a regulatory asset, is purported to be considering compliance requirements for the establishment of a regulatory asset.

We concur with DRA that Commission policy should not be driven by whether or not utilities can record a regulatory asset under Statement 71. Consistent with our position that rate recovery should not be governed by IRS/ERISA requirements, recovery should not be governed by SEC policy or by SEC staff requirements or review.

The utilities should establish a regulatory asset in their regulatory and external financial<sup>27</sup> statements to reflect their yearly differences, if any, between their PBOP expense determined in accordance with the statement and their tax-deductible contributions recovered in rates. Recovery of tax-deductible contributions in any given year should not increase over the prior year's PBOP expense recovery by more than 1% of the utilities' total prior year's operating revenue to mitigate potential rate shock. The establishment of a definitive level for rate shock in this proceeding is based solely on the facts and circumstances applicable to PBOP. The definitive level is not, and should not be viewed as a precedent for any other proceeding. Additionally, the 1% control is intended to be used as an incentive to the utilities in maintaining management control over the

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27 We have no jurisdiction over external financial statements. Our recommendation for such statements is advisory only.

ultimate level of PBOP. Recovery of the regulatory asset should begin during the year when tax-deductible limits exceed PBOP costs and continue until the regulatory asset has reached a zero balance.

Although the parties to this investigation recommended that regulatory assurance language be included in rate orders which address rate recovery of PBOP costs, no witness suggested specific language. The first suggestion came in Edison's brief. Edison provided the following language as intended to meet the FASB regulatory assurance criteria:

- a. Any accrued annual PBOP expense under the Statement in excess of PBOP expense recovered in rates shall be deferred as a regulatory asset.
- b. All PBOP expense deferred in the above ordering paragraph shall be recovered in future rates. Recovery of this deferral in rates will begin no later than during the year when tax-deductible limits exceed PBOP expense calculated under the Statement. This recovery would then continue until the regulatory asset is eliminated.

Edison's proposed language is reasonable for the energy, water, and telecommunications utilities under traditional cost of service regulation and should be adopted after being clarified in two respects: First, to reflect that only accrued annual PBOP expense, calculated in accordance with the Statement, resulting from reasonable PBOP costs will be recorded as a regulatory asset in their external financial statements and recovered in future rates. Second, to ensure that the yearly PBOP expense is calculated in accordance with the Statement procedure, as modified in this order to reflect the employees' total utility service life attribution method and a 20-year TBO amortization period.

"Reasonable PBOP costs" will be those applicable to regulated services that meet the Statement criteria as modified by

this order, that are invested in tax-deductible plans administered by an independent trust, that the Commission finds are reasonable and necessary to meet funding requirements based on fair actuarial assumptions, contributions, and investments, and that are not used to enhance pension benefits.

b. NRF Incentive Regulation

DRA also recommended that a regulatory asset be established for GTEC and Pacific Bell, both of which are under the NRF.<sup>28</sup> In support of its recommendation DRA explained that these utilities currently have regulatory assets recorded in their financial statements. DRA observed that both utilities intend to record a new regulatory asset resulting from adoption of a different FASB statement, FASB 96.

Pacific Bell clarified that all regulatory assets currently reflected in its financial statements are supported by Commission rate orders that were in place prior to NRF implementation and that future recovery of the deferred costs associated with those orders was built into its start-up revenue adjustment. However, in order to defer new costs under Statement 71, a specific order promising future recovery is needed.

GTEC believes that the recovery issue is much more difficult for utilities operating under incentive regulation because of the limited recovery methods available in the NRF process. To the extent that such new costs are not included in the

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<sup>28</sup> Under NRF a sharing mechanism is used, whereby any utility earning above a benchmark rate of return set 150 basis points higher than the expected market-based rate of return will be shared equally between shareholders and ratepayers. A cap on returns equal to 500 basis points above the market-based rate of return is also established above which all excess earnings would be returned to ratepayers.

Gross National Product Price Index (GNPPI), it believes that recovery must be specifically granted via the "Z" factor.<sup>29</sup>

GTEC further believes that if Z factor recovery is approved it would be difficult to record a regulatory asset absent specific language as to the recovery amounts and time period, and absent scrutiny of the recovery plan. For example, any further reregulation prior to completion of the deferral period should be evaluated to determine if the PBOP expenses associated with the new deregulated services can continue to be recovered after deregulation occurs. GTEC contends that if recovery cannot continue, then the associated regulatory asset must be written off immediately.

We have already concluded that the Statement should be adopted for regulatory accounting and ratemaking purposes with adjustments, and have established recovery language in our discussion on traditional cost of service regulation. Our consideration of Z factor recovery for NRF utilities follows in Section XIV.

GTEC's deregulation concern is premature. For example, yellow page directory services and inside wire services developed at ratepayers' expense and subsequently detariffed or deregulated are currently reflected in the NRF sharing calculation. Any concern regarding recovery of PBOP costs associated with future deregulated services should be addressed in the proceeding that considers deregulation of those services.

The utilities under NRF should establish a regulatory asset in their regulatory financial statements to reflect yearly differences, if any, between their PBOP expense determined in

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<sup>29</sup> Z factor is an adjustment to the price cap formula which reflects cost increases beyond those which will be picked up in the economy-wide inflation factor of the NRF formula.



accordance with the statement and their allowable tax-deductible contributions. We advise these two utilities to provide similar treatment in their external financial statements.

## **2. Rate Base Consideration**

The utilities were divided as to whether the regulatory asset should be given rate base treatment. However, DRA recommended that regulatory assets should not receive rate base treatment and that if we determined it imprudent to fund PBOP costs beyond some level, ratepayers should not be burdened with the responsibility to pay a return on funding PBOP in excess of the prescribed level. DRA took this position because the utilities would not be funding the regulatory asset. According to DRA, its position to exclude the PBOP regulatory asset from rate base was also the position of Edison, PG&E, and SoCal Gas.

Three utilities recommended that rate base treatment be given to the PBOP regulatory asset. The utilities that recommended such treatment were GTEC, Pacific Bell, and SDG&E. However, SDG&E clarified that rate base treatment was dependent on whether its regulatory asset was being funded.

DRA recommended that the utilities be ordered not to include any PBOP regulatory assets in rate base without explicit authorization to do so. There was very little testimony on this issue. However, because the regulatory asset will not impact the utilities' cash flow until the utilities are able to make additional tax-deductible contributions, we concur with DRA and will adopt DRA's recommendation that PBOP regulatory assets not be included as part of rate base.

## **XII. Legislative Impacts**

In opening this investigation we were generally aware that Congress was considering a bill which, if passed, would allow the transfer or use of excess pension assets for PBOP. We